Supreme Court, U.S.
FILED
MAR 13 1996
CLERK

No. 95-323

In the Supreme Court of the United States

OCTOBER TERM, 1995

UNITED STATES OF AMERICA, PETITIONER

v.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR
FIRST TRUCK LINES, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

DREW S. DAYS, III
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

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The court of appeals recognized that Congress—writing with precision and detail—expressly provided postpetition tax penalty claims of the type involved in this case with a statutory "[f]irst" priority in the distribution of the assets of the debtor's estate (Pet. App. 3a). See 11 U.S.C. 503(b)(1)(C), 507(a)(1). The court stated, however, that it did "not see the fairness or the justice" of that legislative determination (Pet. App. 19a):

> We do not see the fairness or justice in permitting the * * * claim for tax penalties * * * to enjoy an equal or higher priority with claims based on the extension of value to the debtor * * *.

Believing that "fairness" and "justice" support the view (which Congress evidently did not share) that "claims based on extension of value to the debtor" should be paid before postpetition tax penalty claims, the court annulled and reversed the statutory priorities that Congress provided. The court did so quite emphatically and directly, by changing the priority for the tax penalty claims in this case from "[f]irst" to "last."

For the reasons detailed in our opening brief, the "principles of equitable subordination" that are codified in Section 510(c)(1) of the Bankruptcy Code (11 U.S.C. 510(c)(1)) do not support this judicial reinvention of the priority provisions of the Code. By allowing the court's own view of what is "fair" or "unfair" to override the express congressional determination of the priority to be afforded to these competing claims, the court of appeals violated the fundamental principle that a bankruptcy court's equitable powers "must and can only be exercised within the confines of the Bankruptcy Code" (*Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206 (1988)). Principles of equitable subordination do not permit a court "to contradict statutory or common law when [it] feels a fairer result may be obtained by application of a different rule." *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 787 (9th Cir), cert. denied, 423 U.S. 913 (1975). They do not permit a court to say, "in effect * * * , 'No, the distribution scheme provided by [Congress] is a mistake.'" 516 F.2d at 788.

As this Court summarized in *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211 (1948), the doctrine of equitable subordination has the quite different and narrower function of punishing creditors who engage in inequitable misconduct, by

"depriv[ing] the wrongdoer of the fruits of his wrong." *Id.* at 229. See also Pet. Br. 10-16. It is undisputed that the United States did not engage in any inequitable conduct in this case. The doctrine of equitable subordination therefore simply does not apply.

Respondent advances several arguments in support of the decision below. None of respondent's contentions substantiates the untenable proposition that, by codifying the preexisting "principles of equitable subordination," Congress authorized the courts to annul and disregard the hierarchy of detailed statutory priorities that Congress enacted to govern the rights of innocent claimants in bankruptcy cases. All but two of respondent's contentions are addressed in our opening brief. We reply here to the two contentions not previously addressed.

1. Respondent claims that there is a "bankruptcy policy of favoring pecuniary loss claims over nonpecuniary loss claims" and that "nonpecuniary loss tax penalties * * * have traditionally been disfavored" in bankruptcy (Resp. Br. 9, 20-21). These assertions are neither relevant nor factually correct.

Even if one could identify a source (other than the provisions of the Code) to determine what is "bankruptcy policy" and what is not, such "policy" has no lawful force if it has not been enacted as positive law. A court's perception of "policy" (as well as its perception of "fairness" and "justice") can not justify countermanding the statutory priorities that Congress has enacted. *E.g.*, *United States* v. *Killoren*, 119 F.2d 364, 366 (8th Cir.) ("[t]he plain mandate of the law cannot be set aside because of considerations which may appeal to referee or judge as falling within general principles of equity jurisprudence"), cert.

denied, 314 U.S. 640 (1941); *In re Columbia Ribbon Co.*, 117 F.2d 999, 1002 (3d Cir. 1941) (a "court may not by granting a priority which it deems equitable set aside the clear congressional mandate that no such priority shall be accorded").

Moreover, respondent's broad contention that "bankruptcy policy" disfavors nonpecuniary loss penalties is demonstrably incorrect. One need look no further than to Sections 503(b)(1) and 507(a)(1) of the Bankruptcy Code, which provide "[f]irst" priority for postpetition tax penalty claims, to see that "bankruptcy policy" is far more complex and articulated than respondent contends.[1] As this Court has explained, by providing a statutory priority for postpetition tax penalties, Congress sought to advance the legislative policy of ensuring compliance with the

[1] The only category of tax penalties that is "disfavored" in bankruptcy is *pre*petition nonpecuniary loss penalties in Chapter 7 cases. See 11 U.S.C. 726(a)(4) (subordinating such prepetition penalties to general unsecured claims). By contrast, as the court of appeals acknowledged, in providing a "[f]irst" priority for postpetition tax penalty claims, Congress did "not distinguish between tax penalties that are compensatory in nature and those that are not" (Pet. App. 15a). As we discuss in our opening brief (Pet. Br. 19 n.6), Congress has made detailed distinctions in the priorities provided to tax penalty claims in various differing contexts under the Bankruptcy Code. See Pet. App. 14a-15a ("In Chapter 7 cases, Congress assigned differing priorities to pre- and postpetition penalties. 11 U.S.C. §§ 726(a)(1) and 726(a)(4). * * * Section 726(a)(1) gives administrative expense priority to *postpetition* tax penalty claims."). The careful distinctions that Congress made in providing differing bankruptcy priorities for different types of tax penalty claims would be rendered meaningless if courts were permitted to apply "principles of equitable subordination" to disregard and annul the statutory priorities. See Pet. Br. 20-21.

tax laws by debtors in bankrupcy and thereby ensuring that such debtors abide by the same rules of law that apply to every other business (including those with whom they compete). *Nicholas* v. *United States*, 384 U.S. 678, 694 (1966); *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939).[2]

Although the court of appeals evidently disagreed with the policy judgment that Congress thus made in providing a "[f]irst" priority for postpetition tax penalty claims, the court was nonetheless bound by that legislative determination. As this Court emphasized

[2] Respondent errs in seeking to rely on *Simonson* v. *Grandquist*, 369 U.S. 38 (1962), as support for the proposition that penalty claims are disfavored in bankruptcy (Resp. Br. 21). Prior to 1978, *pre*petition penalty claims had been disallowed by statute under Section 57(j) of the Bankruptcy Act, 11 U.S.C. 93(j) (1976). *See Simonson* v. *Granquist*, 369 U.S. at 40. Although the Court stated in *Simonson* "that the language of §57(j) broadly prohibits the allowance of penalty claims in bankruptcy" (369 U.S. at 39), that statement was necessarily limited to the *pre*petition tax penalties involved in that case. In *Boteler* v. *Ingels*, which was decided two decades before *Simonson*, a unanimous Court had held that Section 57(j) did *not* bar a claim for *post*petition penalties incurred by the trustee. 308 U.S. at 61. And, four years after *Simonson*, the Court reaffirmed that holding in *Nicholas* v. *United States*, in concluding that the government's claim for a *post*petition tax penalty was allowable and entitled to first priority in distribution. 384 U.S. at 694 ("the United States is entitled to exact the penalties here in question as a legitimate means to enforce the prompt filing of the tax returns"). As noted in our opening brief (Pet. Br. 21 n.8), the majority and concurring opinions in the court of appeals overlooked *Nicholas* and *Boteler* and thereby erred in stating, without qualification, that "prior to 1978, nonpecuniary loss tax penalty claims against the estate of the bankrupt were not allowed by law" (Pet. App. 12a; see *id.* at 22a).

in *United States* v. *Sotelo*, 436 U.S. 268, 279 (1978), "[h]owever persuasive [alternative policy] considerations might be in a legislative forum, we as judges cannot override the specific policy judgments made by Congress in enacting the statutory provisions with which we are here concerned." See also Pet. Br. 14-16 & n.2.

2. Respondent contends that, even though Congress conferred a "[f]irst" priority on postpetition tax penalty claims as a matter of law, such claims should be subordinated as a matter of "equity" (even "without a finding of inequitable conduct" (Resp. Br. 24)) in order to avoid a perceived inconsistency with other provisions of the Bankruptcy Code.[3] Respondent grounds this contention on the theory that the statutory priority for postpetition tax penalty claims is "misguided" and should not be enforced (*id.* at 25).

But that assertion is nothing more than a contention that courts should disregard the priorities

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[3] Respondent suggests that equitable subordination of tax penalty claims is "not automatic" under the analysis of the court of appeals but is instead to "be determined on a case by case basis" (Resp. Br. 14). That description of the decision below is not correct. The court of appeals held that tax penalty claims are to be subordinated solely because it would be more "fair" for creditors "with claims based on the extension of value to the debtor" to be paid first (Pet. App. 19a). That rationale, if valid, would apply in every bankruptcy case involving an estate without sufficient assets to pay the claims of all creditors. In the rare case in which the estate has sufficient assets to satisfy all claims, there would be no need to invoke the doctrine of equitable subordination—for all claims would then be paid. Moreover, even on "a case by case basis", courts are not permitted to disregard statutory priorities soley on the theory that a *different* priority scheme might be more "fair" in a particular case. See Pet. Br. 9-16.

enacted by Congress if they conclude that "the distribution scheme provided by the [Bankruptcy Code] is a mistake" (*Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788). It is unquestionably not the function of a court of equity, however, to "contradict statutory or common law" merely because the chancellor "feels a fairer result may be obtained by application of a different rule." *Id.* at 787. See Pet. Br. 11-17.

Moreover, there is nothing "misguided" about the detailed and complex set of priorities that Congress established in the Bankruptcy Code. Respondent complains that a "[f]irst" priority for tax penalty claims would require "any party doing business or extending credit postpetition to a trustee or debtor in possession" to demand "superpriority status before providing goods or services" (Resp. Br. 24). The "superpriority" provisions of the Bankruptcy Code permit a party who extends credit to the debtor after the petition is filed to obtain a priority "over any or all administrative expenses" but only if, *inter alia*, the trustee is otherwise unable "to obtain unsecured credit" (11 U.S.C. 364(c)(1)). Respondent suggests that the "delays" inherent in obtaining authorization for "superpriority" status from the bankruptcy court "could be fatal" to a debtor, and would therefore be "contrary to the strong bankruptcy policy in favor of rehabilitating or reorganizing debtors" (Resp. Br. 24). Respondent thus seems to contend that the priority that Congress established for postpetition tax penalty claims will frustrate the entire object of the Bankruptcy Code.

It could as easily be contended that, if Congress had determined *not* to provide a first priority for postpetition taxes and tax penalties, that determination

would have frustrated the entire object of the Internal Revenue Code.[4] The balancing of competing policy objectives is an inherently legislative function. Congress has performed that policy function by enacting the complex and detailed scheme of priorities set forth in the Bankruptcy Code. It is not the proper task of the bankruptcy courts to nullify the choices that Congress made based upon the court's differing perception of "fairness" and "justice" (Pet. App. 19a).[5]

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[4] In enacting the priority scheme of the Bankruptcy Code, Congress obviously gave a high priority to ensuring tax law compliance. It seems hardly necessary to point out that the dilemma that respondent poses—the threatened frustration and collapse of the entire bankruptcy scheme of reorganization—is most unrealistic. Respondent's stated concerns are obviously entirely irrelevant to a debtor that complies with its lawful duties under the Internal Revenue Code and thereby avoids the accrual of priority postpetition tax penalties. Moreover, the conditions precedent to the allowance of "superpriority" status have nothing to do with the risk of tax penalties—they are related to whether the credit status of the debtor is such that unsecured credit is not available. See 11 U.S.C. 364(c).

[5] Respondent's extended discussion (Resp. Br. 21-22 n.14) concerning the priority to be afforded to prepetition penalty claims in a case under Chapter 11 is irrelevant to this case, which involves the priority to be afforded to a postpetition first priority claim in a case under Chapter 7.

For the foregoing reasons and those set forth in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

MARCH 1996